DISTRIBUTION OF ASSETS OF BANKRUPT PARTNERSHIPS AND PARTNERS.

UNDER the Bankruptcy Law of 1898[1] the assets of bankrupt partnerships and partners are to be distributed as follows: "The net proceeds of the partnership property shall be appropriated to the partnership debts, and the net proceeds of the individual estates of each partner to the payment of his individual debts. Should any surplus remain of the property of any partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be added to the assets of the individual partners in the proportion of their respective interests in the partnership."

If Congress desired a convenient method of distribution, this sub-section attains that end. Moreover, it has, when viewed without regard to the balance of the act of 1898, the sanction of time-honored precedent. The English bankruptcy legislation of 1883[2] and 1849[3] and the United States acts of 1867[4] and 1841[5] contain sections almost identical in their application. In the English Bankruptcy Act of 1825[6] we find: "And be it enacted, That in all Commissions against One or more of the Partners of a Firm any Creditor to whom the Bankrupt or Bankrupts is or are indebted, jointly with the other Partner or Partners of the said Firm, or any of them, shall be entitled to prove his Debt under such Commission for the Purpose only of voting in the choice of Assignees under such Commission, and of assenting to or dissenting from the Certificate of such Bankrupt or Bankrupts, or of either of such Purposes; but such Creditor shall not receive any Dividend out of the separate Estate of the Bankrupt or Bankrupts until all the separate Creditors shall have received the full Amount of their respective Debts, unless such Creditor shall be a Petitioning Creditor in a Commission against One Member of a Firm." This section, the statutory parent of more recent legislation, was itself

[1] § 5 f.
[2] St. 46 & 47 Vict. c. 52, § 40 (3).
[3] St. 12 & 13 Vict. c. 106, § 140.
[4] 14 Stat. L. 517, § 36.
[5] 5 Stat. L. 440, § 14.
[6] St. 6 Geo. IV. c. 16, § 62.

intended to be declaratory of the then existent law, as found in the chancery decisions. The doctrine which it espouses was first suggested in *Ex parte* Crowder, decided by Lord Harcourt in 1715.[1] In 1728 the suggestion was endorsed by Lord Chancellor King, who speaks of the rule as settled and characterizes it as a "resolution of convenience."[2] Lord Hardwicke adopted it without comment.[3] Almost half a century later Lord Thurlow disapproved of it on principle and permitted the joint creditors to come in against the separate estate *pari passu* with the separate creditors.[4] He was in turn overruled by Lord Loughborough in 1796. *Ex parte* Elton, which is cited as the overruling case, was one in which there were two funds, in one of which the joint creditors had a preference, and it was held that the joint creditors "must get as much as they can from that *first*."[5] It will be noted that this decision merely enforced the well-recognized equitable principle of marshaling assets. This case was followed by one in which a joint creditor sought to participate in the separate estate of one of eight partners, there being no joint fund, and no proceedings against the other obligors. The Attorney-General argued the inconvenience of compelling the bankrupt's assignee to seek contribution from seven partners, not parties to the action, and cited *Ex parte* Elton in support of his position. Lord Loughborough extended the effect of his previous decision, and refused to permit the partnership creditors to share in the separate estate.[6] Lord Eldon followed Loughborough merely because he thought it better "to follow the rule that he found established, than to let it be continually changing, so no one can tell how it is."[7] In a review of the history of this rule, he took occasion to state that he had "often doubted whether it was the best in principle."[8] The act of 1825 followed. It will be noted that the authority in support of this rule is based on convenience, and that the one Lord Chancellor who felt himself at liberty to act on principle, refused to adopt it. The influence of these decisions upon bankruptcy legislation has been "seed cast into time, which grows, and spreads, and

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[1] 2 Vern. 706.

[2] *Ex parte* Cook, 2 P. Wms. 500.

[3] *Ex parte* Hunter, 1 Ark. Just. 223, 228, 1742.

[4] *Ex parte* Cobham, 1 Bro. C. C. 576, 1784; *Ex parte* Hodgson, 2 Bro. C. C. 5, 1785; *Ex parte* Page, 2 Bro. C. C. 119; *Ex parte* Flintum, 2 Bro. C. C. 120.

[5] 3 Ves. 239.

[6] *Ex parte* Abell, 4 Ves. 837.

[7] *Ex parte* Clay, 6 Ves. 813, 1802; *accord, Ex parte* Chandler, 9 Ves. 35; *Ex parte* Taitte, 16 Ves. 193.

[8] Dutton *v.* Morrison, 17 Ves. 193, 207, 208.

sows itself anew." It has impelled the majority of modern courts to adopt this method of distribution even in cases not governed by statute.[1]

However idle this weight of authority might render any discussion of the underlying principles which should govern distribution where the English legal idea is accepted, it is submitted that this authority is of no force where a different theory of the nature of a partnership prevails. An examination of the act of 1898 will disclose a departure from previous bankruptcy legislation involving a radical change in the theory of the nature of a partnership. The act provides that the term "persons" shall include partnerships;[2] a partnership may be adjudged a bankrupt; the creditors of the partnership shall appoint the trustee, and the partnership estate shall so far as possible be administered as other estates; jurisdiction over one partner gives jurisdiction over the partnership; the partnership may prove against the individual estates and the individual estates against the partnership estate.[3] In the earlier bankruptcy legislation of the United States, section 14 of the act of 1841 and section 36 of the act of 1867 provide that "*where two or more persons who are partners* in trade are adjudged bankrupt" the certificate of discharge shall be granted "*to each partner* as the same would or ought to be if the proceedings had been against him alone." Under the old English practice it was necessary to take out simultaneously a joint commission against all the partners and also a separate commission against each. If for any reason a commission could not be maintained against one, a joint commission against the others could not be supported. In order to support a petition against a firm, each of the partners must have been proved to have committed an act of bankruptcy.[4] Under the modern English practice a receiving order made against a firm will operate as if it were a receiving order against each partner; the adjudication is not against the firm in the firm's name, but against all the partners individually.[5] These distinctions are more than verbal. They go to the essence of the nature of a partnership. Under no act other than that of 1898 could the bankruptcy of a partnership

[1] Bates on Partnership § 825, note, contains citations from 26 states in which this method of distribution has been adopted either under or in the absence of statutes. These cases seek some principle on which to rest, and many novel equities are discovered to meet the demand.

[2] Bankruptcy Law of 1898 § 1 (19).

[3] Act of 1898 § 5.

[4] Robson's Bankruptcy pp. 678, 679, 680.

[5] Act of 1883 Rules 262, 264.

be adjudged, or its estate, as such, be administered. Joint commissions were essentially commissions against the individuals, operating upon the estates of each of the partners, and not maintainable except where separate commissions could be supported against each partner. "It was a prerequisite that all persons comprising the partnership be adjudged bankrupt before a warrant could issue entitling the assignee to administer the joint estate."[1]

Under the act of 1898, a firm, as such, may be bankrupt, and the individuals composing it solvent.[2] Hence, where an act of bankruptcy in which one partner did not participate, has been committed by an insolvent firm, the partnership and the participating partner may be adjudged bankrupt in an involuntary proceeding, though the court has no jurisdiction in such proceeding so to adjudicate the non-participating member. So, too, where one of the partners was a minor, the partnership and the partner who was of age were adjudicated bankrupt, and the petition dismissed as against the minor partner.[3] And the insanity of a partner and the appointment of a conservator of his estate will not prevent an adjudication of bankruptcy against the partnership.[4] It is the scheme of our act "to treat the partnership as an entity which may be adjudged a bankrupt by voluntary or involuntary proceeding, irrespective of any adjudication of the individual partners as bankrupt."[5] Consequently it has been held that the statutory filing fee must be deposited by the partnership and by each partner seeking the benefits of the act.[6]

These suggestions embody the recognized results of the new view of the nature of a partnership. This view is new only in the frankness of its expression in our system of jurisprudence. It is the common-sense view, the mercantile view, and the juridical view in the Roman, Continental, and Scotch systems. It is the view which has been gaining followers in the United States and recognition by the legislatures and the courts.[7] Inasmuch as

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[1] *In re* Cook, Fed. Cas. 3150; *In re* Weaver, Fed. Cas. 17307; *In re* Shephard, Fed. Cas. 12754; *In re* Redmond, Fed. Cas. 11632; *In re* Meyer, 98 Fed. Rep. 976, 979 (C. C. A.), aff. 92 Fed. Rep. 896.

[2] *In re* Sanderlin, 109 Fed. Rep. 857; *In re* Grant Brothers, 5 Am. B. Rep. 837, 839.

[3] *In re* Dunnigan, 95 Fed. Rep. 428; *In re* Duguid, 100 Fed. Rep. 274.

[4] *In re* L. Stein & Co., 127 Fed. Rep. 547.

[5] *In re* Meyer, n. 1 *supra*.

[6] *In re* Barden, 101 Fed. Rep. 553; *In re* Farley, 115 Fed. Rep. 359. *Contra*, *In re* Langslow, 98 Fed. Rep. 869; *In re* Gay, *ibid.* 870; *cf.* *In re* Grant Bros., 5 Am. B. Rep. 839.

[7] Neither courts nor legislatures have frankly recognized the entity of a partner-

bankruptcy legislation usually declares the existent substantive law, the act of 1898 has, even by its partial recognition of the "entity" view, performed a valuable service in calling attention to the fact that the courts have already done the legislating, and that "to admit the fact is all that remains for them to do." That the recognized method of distribution of partnership and individual assets finds no support in principle even under the common law view, renders doubly unfortunate the failure of the act to apply the principles necessarily inherent in its view of the nature of a partnership.

These principles must be sought in the law of partnership. That the interest of each partner in the partnership property is his proportion, after the payment of the partnership debts, is a fundamental proposition.[1] It follows, since the right of the individual creditors of each partner is to look to the property of that partner, that the individual creditors have no claim against the partnership assets, as such, but are limited to the distributive share of their debtor. This share does not become the separate property of the partner until the payment of the partnership debts. It becomes evident that it is because of the nature of the partner's interest that the individual creditors are postponed to the partnership creditors in the distribution of the partnership assets. The priority of the partnership creditor is a necessary consequence, and his so-called subrogation to the right of each partner to compel the application of the partnership assets to the partnership debts, is as unnecessary in the explanation of this priority as it is incorrect as a statement of sound legal theory.[2] This priority is conceded where the common law view of the nature of a partnership prevails. It is also a necessary consequence of the adoption of the "entity" view, since the individual creditors manifestly have no rights against the juristic person with whom they have had no dealings.

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ship, but both have provided for a partial recognition. For such action by the courts, see "The Firm as a Legal Person," 57 Cent. L. J. 343. For Legislative Recognition, see Stimson, Am. Stat. Law §§ 1304, 1370, 5305, 5323, 5340 *et seq.*, 8100–8106. See also 22 E. & A. Ency., 2d ed., 76, n. 9.

[1] Parsons on Partnership, 4th ed., § 178, p. 231; Lindley on Partnership *340; United States *v.* Hack, 8 Pet. (U. S.) 271, 275; Case *v.* Beauregard, 99 U. S. 119, 124; Menagh *v.* Whitwell, 52 N. Y. 146; Pratt *v.* McGuinness, 173 Mass. 170.

[2] See "The Firm as a Legal Person," 57 Cent. L. J. 343, and cases collected *ibid.* 345, n. 24, and 347, n. 34. *Cf.* Arnold *v.* Hagerman, 45 N. J. Eq. 186; Bannister *v.* Miller, 54 N. J. Eq. 121; Darby *v.* Gilligan, 33 W. Va. 246; Elliott *v.* Stevens, 38 N. H. 311; *Ex parte* Snowball, L. R. 7 Ch. App. 534.

The partnership principle, upon which the right of the partnership creditor to look to the estate of the individual partner rests, is that each partner is liable for the whole of the partnership debts.[1] This liability is secondary. Where the common law view of the nature of a partnership prevails, the liability of each partner *in solido* is secondary to the joint liability of all. Under the theory of the bankruptcy act, each partner occupies the position of surety for the firm. On the default of a principal obligor, the liability of his surety becomes absolute. A creditor is allowed to prove against the estate of the surety on this absolute liability, regardless of the financial condition of the principal.[2] The decisions under the common law view of the nature of a partnership, which make an arbitrary exception to the arbitrary rule of distribution, in permitting the partnership creditors to prove *pari passu* with the individual creditors in the absence of solvent partner or partnership assets,[3] though explained on a mistaken notion of the equity rule of marshaling,[4] can be supported on no other ground than that of the absolute liability of the partner on the default of the partnership. Proof against the estate of the partnership, the principal obligor, should in no way prejudice the right of the creditor to prove against the estate of the partner, the surety.[5] To prejudice this right is, in effect, to admit that the law, which gives to the partnership creditor the security of the individual liability of the partner, deprives him of that security in whole or in part, as soon as its possession becomes of value. Of course, the creditor should not be permitted to recover more than one hundred per cent of his claim, but such defense as the partner might have against such recovery, would go to the amount of the recovery, and not to the time or amount of the proof.

The Bankruptcy Act, in acknowledging the entity of a partnership, must perforce acknowledge that the relation of a partner to his firm's liabilities is that of a surety. A method of distribution

[1] Lindley on Partnership *200; Parsons on Partnership, 4th ed., 328, 329.

[2] 5 HARV. L. REV. 406.

[3] *In re* West, 39 Fed. Rep. 203; *In re* Downing, 3 N. B. Rep. 748; *In re* Rice, 9 N. B. Rep. 373. Under the act of 1898 this exception appears to have been retained. *In re* Green, 116 Fed. Rep. 118; *In re* Conrader, 118 Fed. Rep. 676. *Contra, In re* Wilcox, 94 Fed. Rep. 84, 107; *In re* Mills, 95 Fed. Rep. 269.

[4] *In re* Wilcox, *supra.*

[5] *Ex parte* Marshal, 1 Atk. 129; Lord Eldon in *Ex parte* Rushforth, 10 Ves. 409; *In re* Pulsifer, 14 Fed. Rep. 247; *In re* Myers, 78 Wis. 615; Williams *v.* Importers' Bank, 44 Ill. App. 295, 297; *In re* Bates, 118 Ill. 524; Citizen's Bank *v.* Patterson, 78 Ky. 291, 295; *In re* Souther, *Ex parte* Talcott, 2 Low. (U. S. Dist. Ct.) 320.

which denies a firm creditor the same right against a partner surety which it allows against a surety for a partnership, who is not such by reason of being a member of the firm, is, to say the least, anomalous. The provisions which postpone the partnership creditor to the individual creditor in participating in the individual assets are unsound in principle and not in harmony with the balance of the act.

There is, however, one principle of equity which might reduce the amount upon which dividends would be paid from the estate of the individual partner, namely, the principle of marshaling. The partnership estate and the individual estate of the partner constitute two funds in the hands of the bankruptcy court, both of which may, in the first instance, be resorted to by the partnership creditors, and one only by the individual creditors. Equity would compel the partnership creditors to exhaust the partnership estate before resorting to that of the partner. Whether or not this would reduce the amount upon which dividends should be allowed from the individual estate would depend upon whether the court adopted the theory that the amount upon which dividends should be allowed is that due at the time of distribution, or that due at the time of proof.[1] If the former view be adopted the partnership creditor's claim against the individual estate should be reduced by the amount received from the partnership estate, but he should in no event be postponed to the individual creditors.

Whichever of these views is adopted, the same results follow from the application of a third rule of the substantive law of partnership, without regard to the equity rule of marshaling. Each partner has a so-called lien or equity to compel the application of the firm assets to the payment of the partnership debts.[2] This

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[1] Authorities on these conflicting theories are irreconcilable. The following seem to support the view that the amount upon which dividends should be allowed is that due at the time of distribution. Security Investment Co. *v.* Bank, 58 Kan. 414; Delaware Co. *v.* Oxford Co., 38 N. J. Eq. 151; State Nat. Bank *v.* Esterly, 69 Oh. St. 24; Savings Bank *v.* Woodward, 137 Mass. 412; Bank *v.* Bank, 80 Md. 371, 382, 383; Whitaker *v.* Bank, 52 N. J. Eq. 400, 418; State *v.* Nebraska Savings Bank, 40 Neb. 342, 352, and cases cited 58 Cent. L. J. 111, n. It will be noted that many of these decisions are in cases in which the securities exhausted belonged to the estate of the insolvent, and the courts looked upon the amounts realized as payments by that estate. The following seem to support the contrary view. Cases cited in n, 5, p. 500; cases cited in 58 Cent. L. J. 111, n.; Merrill *v.* Nat. Bank, 173 U. S. 132; Furness *v.* Union Nat. Bank, 147 Ill. 570, 573; Kellogg *v.* Miller, 22 Ore. 406, and cases therein cited.

[2] Lindley on Partnership * 351; Bates on Partnership § 820, p. 867.

equity is sometimes said to be based upon an implied term of the partnership articles. The doctrines of suretyship make a resort to this implication unnecessary. As has been seen, under either view of the nature of a partnership, the individual liability of a partner is secondary. He has the surety's right to exoneration by his principal, which right matures with the maturity of the obligation.[1] This right to exoneration would compel the application of partnership assets to partnership debts before recourse is had to the individual estates, whenever the court has jurisdiction over partners and partnership.

The remaining partnership principle which enters into the distribution of the firm and individual assets, is that a partner paying a partnership debt is entitled to reimburşement from the partnership, or contribution from the partners, *after the creditors of the firm have been satisfied*, provided a balance is due him on a statement of the partnership account.[2] This right to reimbursement and contribution also finds its explanation in the equitable doctrines of suretyship.[3] The exercise of this right is postponed until the partnership creditors have been satisfied, because each partner is surety for every debt of the partnership and hence cannot equitably compete with the firm creditors.[4] The situation is analogous to that of a surety on several notes secured by the same collateral. On paying one of the notes he is not entitled to subrogation to its holder's rights, so as to compete with the holders of the remaining notes.[5] "Indemnification and not profit is the measure of the surety's recourse" against both the principal and the co-surety. The right to reimbursement from the partnership estate is limited to the amount actually paid by the partner or his estate. The surety cannot profit at the expense of his princi-

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1 See Ames, Cases on Suretyship 598, n. and cases cited.

2 Collyer on Partnership, 6th ed., § 109; Bates on Partnership § 836, p. 893; Lindley on Partnership * 383, 721 *et seq.*, 740; Coleman *v.* Coleman, 78 Ind. 344, 347; Lyons *v.* Murray, 95 Mo. 23; Gordon *v.* His Creditors, 6 Rob. (Ala.) 328; Fissler *v.* Hickersnill, 82 Pa. St. 150.

3 Pratt *v.* Law, 9 Cranch (U. S.) 456; Simpson *v.* Gardiner, 97 Ill. 237, 241; Haverford *v.* Fire Ass'n, 180 Pa. St. 522; Stebbins *v.* Willard, 53 Vt. 665; Dobyns *v.* Rawley, 76 Va. 537.

4 Amsinck *v.* Bean, 22 Wall. (U. S.) 395, 402; Emery *v.* Bank, 7 N. B. Rep. 217; *Ex parte* Lodge, 1 Ves. Jun. 166; *Ex parte* Maude, L. R. 2 Ch. App. 555; McLean *v.* Johnson, 3 McLean 202.

5 Carithers *v.* Stuart, 87 Ind. 424, 433; Massie *v.* Mann, 17 Ia. 131, 135. *Cf. Ex parte* Marshal, 1 Atk. 129; *Ex parte* Watson, 42 L. T. R. 516; Farebrother *v.* Wodihouse, 23 Beav. 18. See also cases under n. 2, *supra.*

pal.[1] The right to contribution does not arise until a surety has paid more than his share.[2] Hence, unless the payment made before bankruptcy, or the dividend paid from the partner's separate estate, is in excess of his proportionate share of the whole debt, there is no right to contribution. The partner who has paid the whole of a partnership debt should, on the theory of subrogation,[3] be permitted to prove against the other partners to the full amount of the debt, and to receive dividends until reimbursed for all except his aliquot part.[4] But the authorities seem to regard only the right to contribution and to limit the proof to the due proportion of the partner against whom proof is made.[5]

The rule against double proof would bar any right to reimbursement or contribution if the creditor has proved against the estates of the partnership and the partners.[6]

The following have been found to be the rules of substantive law entering into the distribution of the assets of the estates of partners and partnership.

(1) The interest of each partner in the partnership property is his proportion after the payment of the partnership debts.

(2) Each partner is liable for the whole of the partnership debts.

(3) Each partner has an equity to compel the application of the firm assets to the payment of the partnership debts.

(4) A partner paying a partnership debt is entitled to reimbursement from the partnership, or contribution from the partners, provided a balance is due him on a statement of the partnership account.

In the first of these rules we find the justification of the partnership creditor's priority in the partnership assets; in the second, is the basis of the right of the partnership creditor to share in the assets of the individual estates; in the third, we find the

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[1] Succession of Dinkgrave, 31 La. An. 703, 707; Eaton *v.* Lambert, 1 Neb. 339: Martin *v.* Ellerbe, 70 Ala. 326, 338; Coggeshall *v.* Ruggles, 62 Ill. 401; Delaware Co. *v.* Oxford Co., 38 N. J. Eq. 151; Mathews *v.* Hall, 21 W. Va. 510, 514.

[2] Davies *v.* Humphreys, 6 M. & W. 153; *Ex parte* Snowdon, 17 Ch. D. 44; Richter *v.* Heming, 110 Cal. 530, 537; Hooper *v.* Hooper, 81 Md. 155; Bushnell *v.* Bushnell, 77 Wis. 435.

[3] Cases cited in n. 3, p. 502.

[4] Pace *v.* Pace, 95 Va. 792; Hess's Estate, 69 Pa. St. 272; Professor Ames in 5 HARV. L. REV. 406.

[5] *Ex parte* Watson, Buck 449, 455; *Ex parte* Smith, *ibid.* 492. *Cf. Ex parte* Moore, 2 Gl. & J. 167, 172; *Ex parte* Plowden, 2 Deac. 456, 463.

[6] *In re* Bingham, 94 Fed. Rep. 796; Wolmerhausen *v.* Gullick, 2 Ch. 514.

partnership creditor compelled to exhaust the partnership assets before receiving dividends from the individual estates, and in the last, we find an equitable adjustment of the claims of the partners and partnership against one another.

The Bankruptcy Act of 1898 in section 5 f provides for the partnership creditor's priority in the partnership property. Section 5 g, a novelty in bankruptcy legislation, provides for proof for the purpose of securing equitable distribution of the property of the several estates. This act persists in the confusion of the second and third of the above rules, with the result that it perpetuates in the modern view the error which has become law, by common concurrence, under the common law view of the nature of a partnership. The right of the partnership creditor to share in the individual estates *pari passu* with the individual creditors has long been recognized as a necessary consequence of regarding a partnership as an entity.[1] The Scotch rule of distribution is that "upon the sequestration of copartners their separate estates are applicable to the payment *pari passu* of their respective separate debts, *and of so much of the partnership debts as the partnership estate is insufficient to satisfy*."[2] This rule enforces our second and third doctrines of the law of partnership. It is to be regretted that Congress failed to carry these doctrines into effect, despite the excellent precedent in the Scotch law.

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1 Bankruptcy of Partners, 7 Law Quart. Rev. 53; 4 HARV. L. REV. 333.

2 Bell, Dig. of Law of Scotland (1882) 706, quoted in Pollock's Dig. of the Law of Partnership, 6th ed., 146 *et seq.*